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“Just Friends” or Something More? Court Finds Shareholders in Closely-Held Corporation Were Dealing at Arm’s Length

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In *1085372 Ontario Limited v. Kulawick*, 2019 ONSC 2344, the Honourable Justice Penny dismissed an action to set aside a transaction under s. 96(1) of the *Bankruptcy and Insolvency Act*[1] (the “**BIA**”) as a transfer at undervalue or under s. 2 of the *Fraudulent Conveyances Act*[2] (the “**FCA**”) as a fraudulent conveyance. In its analysis, the court decided whether two shareholders were dealing at arm’s length or not, and in so doing, relied on the leading case of the Alberta Court of Appeal in *Piikani Nation v. Piikani Energy Corp*, 2013 ABCA 293 (“***Piikani***”). *Piikani* has been cited approvingly by the Ontario Court of Appeal in *Montor Business Corp. (Trustee of) v. Goldfinger,* 2016 ONCA 406 (“***Goldfinger***”). *Kulawick* provides more comfort to clients in closely-held corporations that the court will not, simply by the nature of the parties’ relationship, find that a transaction was non-arm’s length.

The plaintiff was a creditor of Michael Shumak (“**Shumak**”), who had filed an assignment in bankruptcy on January 23, 2013. The trustee in bankruptcy originally commenced the action seeking relief under s. 96(1) of the BIA and s. 2 of the FCA, and this action was later assigned to the plaintiff. The defendant, Geoff Kulawick (“**Kulawick**”), was a shareholder of the other defendant, Linus Entertainment Inc. (the “**Company**”). Kulawick was also the President/CEO of the Company and ran it with full authority and control. Shumak was also a shareholder of the Company, having invested $1,000,000 in the Company in 2000, and had a shareholding interest equal to Kulawick’s. There was also a third shareholder with a very small interest of 7% of the Company.

In 2010, Shumak (by then in financial trouble) sought to extract his investment back from the Company and between June 2010 and January 2011, received about $100,000 from Kulawick. These payments were not booked as dividends or return of capital, but Kulawick gave evidence that he considered them in substance a return of capital. Ultimately, the two agreed to an arrangement where Kulawick advanced a further $100,000, and an additional $150,000 to be paid over five years as “consulting fees”. The documents (dated March 2011) to support this transaction included a letter agreement documenting the loan and security, a promissory note repayable on December 1, 2011, and a share pledge agreement. Although the initial $100,000 was advanced as contemplated, Shumak could not wait for the consulting fees and the parties agreed to an accelerated payment of the consulting fees at a discount. In that regard, $77,000 was paid to Shumak.

The loan came due on December 1, 2011. Shumak defaulted and on December 20, 2011, Kulawick foreclosed on Shumak’s shares. The plaintiff challenged the transaction that led to Kulawick acquiring Shumak’s shares for only $277,000.

One of the threshold issues for Penny J. was whether Shumak and Kulawick were dealing at arm’s length. Recall that the date of bankruptcy was January 23, 2013, more than one year after the loan and security agreement and, also more than one year after the foreclosure. Section 96(1) of the BIA provides:

> 96 (1) On application by the trustee, a court may declare that a transfer at undervalue is void as against […] the trustee

[…] if

(a) the party was dealing at arm's length with the debtor and

(i) the transfer occurred during the period that begins on the day that is one year before the date of the initial bankruptcy event and that ends on the date of the bankruptcy,

(ii) the debtor was insolvent at the time of the transfer or was rendered insolvent by it, and

(iii) the debtor intended to defraud, defeat or delay a creditor; or

(b) the party was not dealing at arm's length with the debtor and

(i) the transfer occurred during the period that begins on the day that is one year before the date of the initial bankruptcy event and ends on the date of the bankruptcy, or

(ii) the transfer occurred during the period that begins on the day that is five years before the date of the initial bankruptcy event and ends on the day before the day on which the period referred to in subparagraph (i) begins and

(A) the debtor was insolvent at the time of the transfer or was rendered insolvent by it, or

(B) the debtor intended to defraud, defeat or delay a creditor.

In this case, because of the time between the date of bankruptcy and the transaction, if the parties were dealing at arm's length, the one-year period stipulated in s. 96(1) of the BIA would have expired and the plaintiff would not have any remedy under this provision.

Although the term "arm's length" is not defined, sub. 4(5) of the BIA provides that for the purpose of 96(1)(b), related persons are deemed to be ***not*** dealing at arm's length, in the absence of evidence to the contrary. Subsections 4(2) and (3) provide guidance on the meaning and scope of "related persons", and by these provisions, Kulawick and Shumak are ***not*** "related persons". Subsection 4(4) provides that it is a question of fact whether persons not related to one another were dealing at arm's length. However, there is no express guidance on determining when two persons who are not related are or are not dealing at arm's length.

Thus, in this case, Penny J. referred to the case of *Piikani,* which was approved by the Ontario Court of Appeal in *Goldfinger.* In the *Piikani* case, the Alberta Court of Appeal was also asked to look at this term within the context of the BIA (in that case, in relation to s. 95). The Alberta Court of Appeal disagreed with the trial judge who had referred to the definition of "insider" within the meaning of the *Securities Act*. Rather, the Alberta Court of Appeal held that the jurisprudence under the *Income Tax Act* ("**ITA**") provided appropriate principles for determining whether two parties were dealing at arm's length. The term "arm's length" had existed in the ITA for many years before it was incorporated into the BIA.[3] The Court of Appeal stated that this approach relies on the logical assumption that Parliament knows what other statutes say when it incorporates a term that has been defined in the courts in another context. This approach also minimizes the potential for unnecessary conflicts in interpretation.

As a result, the court in *Piikani* adopted, as appropriate guidance, the criteria summarized by the Supreme Court in *McLarty v. R.*, 2008 SCC 26, an ITA case. In that case, Rothstein J. explained that the general concern in non-arm's length transactions is that there is no assurance that the transaction will reflect ordinary commercial dealing between parties acting in their separate interests. Rothstein J. also referred to a CRA tax bulletin that outlined useful criteria developed by the courts: (i) was there a common mind which directs the bargaining for both parties to a transaction; (ii) were the parties to a transaction acting in concert without separate interests; and (iii) was there *de facto* control.[4]

A few years later, in Ontario, the Court of Appeal approvingly referred to *Piikani* in the *Goldfinger* decision, affirming the trial judge's decision finding that a $2.5 million settlement payment to an investor by the bankrupt company, controlled by a close friend, was a transaction where the parties were dealing at arm's length. This finding put the transaction outside of the one-year reviewable period. The Court of Appeal noted that (i) there was no common mind directing the investor and the company, or its principal; (ii) the parties were adverse and on the verge of litigation; and (iii) neither party had *de facto* control over the other.

Turning back to the *Kulawick* decision, the relationship at issue was between two shareholders – one with control of the company, the other without. However, because the transaction was between two individuals and not between a shareholder/director and a corporation, the criteria of "common mind" or " *de facto* control" set out in *McLarty* were of limited value. Thus, Penny J. extracted additional guidance from the cases. He cited Rothstein J.'s comments in *McLarty* that provisions dealing with non-arm's length parties are intended to preclude *artificial* transactions from conferring *benefits* on one or more of the parties.[5] In addition to the criteria established in *McLarty*, Penny J. referred to *Juhasz (Trustee of) v. Cordeiro*, 2015 ONSC 1781 for the proposition that in the context of s. 96(1):

the concept of a non-arm's length relationship is one where there is no incentive for the transferor to maximize the consideration for the property being transferred in negotiations with the transferee. It is intended to address situations in which the economic self-interest of the transferor is, or is likely to be, displaced by other non-economic factors that result in the consideration for the transfer failing to reflect the value of the transferred property.[6]

In other words, rather than focusing on a common mind or control, which are concepts that are apt when considering a transaction between a corporation and a shareholder or director, Penny J. focused on value/benefit and incentive, which relate to the second *McLarty* criteria. The goal of s. 96 is to prevent inappropriate *benefits* being conferred on a party; to prevent transactions where the *incentive* is something other than economic self-interest and results in the consideration not reflecting the *value* of the property. It is presumed that parties that are dealing at arm's length will not be motivated to confer benefits on one party, and will be self-interested to maximize the value realized in any transfer.

As a result, applying the principles to the facts of the case, the concept of a "common mind" or "control" were considered by Penny J., but very briefly. Rather, Penny J. looked carefully at the different incentives of the parties – Shumak wanting to monetize his investment in the company for as much, and as quickly as possible; Kulawick wanting to pay Shumak as little as possible, over a period of time, to acquire his shares. Penny J. elaborated on the various motives underlying Shumak's decision in the transaction – "no interest" in the business of the company, "maximize his return", "not willing to wait for payment", "in exchange for faster payment".[7]

The plaintiff argued that Shumak's financial trouble negated his independent economic interest in his shares, or his ability to negotiate at arm's length on the basis of that independent economic interest. Justice Penny disagreed. While acknowledging that Shumak had a need for money quick, that need did not result in the overbearing of Shumak's will – it led to a rational economic choice.[8] Justice Penny recognized that in the circumstances faced by Shumak, economic self-interest could lead to the acceptance of a lower amount for the shares, if paid sooner. This is not unusual in business.

Further, Penny J. found that the lack of consultation with accountants on the transaction, the structure of the transaction (that some of the loan was advanced through "consulting fees"), or the involvement of a lawyer/friend/director of the Company did not support a finding of a non-arm's length relationship.

In other words, in determining whether, under s. 96(1) of the BIA, parties are dealing at arm's length, one must look deeper than just the relationship between the parties. One must examine the relationship ***and*** the manner in which they are ***"dealing" with each other.*** The plaintiff in *Kulawick* appears to have relied primarily on the close nature of the relations between the persons involved in the transaction, and the fact that such relationships often result in less formalities.[9]

However, determining whether the parties were ***dealing at arm's length*** requires a review of whether, in all of the circumstances, including the nature of their relationship, there was a "common mind" directing the transaction; whether the parties were "acting in concert without separate interests"; and whether any party had "*de facto* control". In certain cases, particularly as between two individuals in a closely-held corporation, the second criteria will be the most informative. The relationship is not determinative. Rather, it is only the context through which the conduct (i.e. the "dealing") is examined. Understanding the arm's length/non-arm's length part of s. 96(1) in this way shows that the types of transactions that will be found to be non-arm's length under the BIA are narrower than one may have initially thought.

[1] R.S.C. 1985, c. B-3.

[2] R.S.O. 1990, c. F.29.

[3] *Piikani* at para. 23.

[4] *Piikani* at paras. 28-29.

[5] *Kulawick* at para. 47 citing *McLarty v. R,* 2008 SCC 26.

[6] *Kulawick* at para. 49.

[7] *Kulawick* at para. 53.

[8] *Kulawick* at para. 56.

[9] See the list of factors put forward by the plaintiff at para. 44 of the decision.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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